

How does a corporation compute earnings and profits (E&P)? What income is deferred to a later year when computing taxable income but is included in E&P in the current year? What deductions are allowed for taxable income purposes but denied for E&P?

Earnings and profits are computed by taking the taxable income or net operating loss and adjusting it. The adjustments come from taxes or non-taxable income. After adding or subtracting taxable income items, tax-exempt items such as life insurance proceeds and tax-exempt interest are added. This is because earnings and profits are what the firm uses to pay dividends.

Gains and losses on property transactions are deferred to a later year but included in earnings and profits. These gains can come from installment sales in which all gain is realized. Other income and deductions are computed on percentages earned such as those for project completions and depreciation.

Some income is not allowed in the computation of earnings and profits, but is used in taxable income. This is because earnings and profits are for paying dividends. Dividends received from other companies or subsidiaries are part of this. Also included in this category are NOL capital loss carryovers, the US production activities deductions, and charitable contributions. This deduction is considered a tax break not a deduction for earnings and profits.

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A corporation's taxable income is decreased by taxes owed and increased by tax-exempt income (tax-exempt income would also be added to the NOL). The taxes would reduce the amount available for dividends and the tax-exempt income would increase the amount to pay dividends.

E & P is adjusted to reflect items previously deducted from taxable income such as tax-exempt interest, proceeds from a life insurance contract (corporation is beneficiary), recoveries of bad debts, deductions where the company received no tax benefit, and federal income tax refunds from prior years.